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BRIEF CASES

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Hill Country Snack Foods Co.

The Chief Executive Officer of Hill Country Snack Foods had never enjoyed analyst conference calls, but in late January of 2012, Howard Keener was yet again asked about the company's cash balances, capital structure, and performance measures. One analyst complained that Hill Country's growing cash position, absence of debt finance, and large equity balance made it difficult for a company in a mature industry to earn a high rate of return on equity, and recommended a more aggressive capital structure. "Maybe I don't fully understand capital structure theory and practice," replied Keener, "but I have observed that companies don't get into trouble because they have too much cash; they get into trouble because they have too much debt." Hill Country had seen its sales and profits grow at a steady rate during Keener's tenure as CEO, and at the end of 2011 the company had zero debt and cash balances equal to 18% of total assets and 13% of market capitalization. Having just celebrated his 62^{nd} birthday, Keener was approaching retirement, creating speculation by investors and analysts that the company might change to a more aggressive capital structure in the near future.

Company Background

Hill Country Snack Foods, located in Austin, Texas, manufactured, marketed, and distributed a variety of snacks, including churros, tortilla chips, salsa, pretzels, popcorn, crackers, pita chips, and frozen treats. Although many of its products had a Southwestern flair, it also offered more traditional snack foods, which were purchased by end consumers thousands of times every day in supermarkets, wholesale clubs, convenience stores, and other distribution outlets. The company's growth and success was driven by its efficient operations; quality products; strong position in a region that was experiencing both population and economic growth; and its ability to expand its presence beyond the aisle into sporting events, movie theaters, and other leisure venues where consumers were more likely to purchase snack foods. Many of Hill Country's products were also sold through school systems, which required the company to reduce the fat and sugar content of its products. This was just one example of the company's continual work to solicit, collect, analyze, and internally distribute customer feedback so the company could quickly react to customer requirements or preferences, and reinvent and expand its products as required to succeed in the rapidly changing marketplace.

HBS Professor W. Carl Kester and Babson College Professor Craig Stephenson prepared this case solely as a basis for class discussion and not as an endorsement, a source of primary data, or an illustration of effective or ineffective management. Although based on real events and despite occasional references to actual companies, this case is fictitious and any resemblance to actual persons or entities is coincidental.

Hill Country's Corporate Culture

Hill Country was a well-managed company, where all decisions were made according to one criterion: will this action build shareholder value? This singular management focus came directly from Howard Keener, the company's CEO for over fifteen years, who strongly believed that management's job was to maximize shareholder value. This philosophy was applied at every level of the organization and in all operating decisions. Many managers talk about shareholder value, but Keener was proud of the fact that, at Hill Country, shareholder value was a way of life, not just a talking point. Keener and other management insiders also held a significant proportion of the company's common stock, approximately one-sixth of the 33.9 million shares outstanding, so this focus on building shareholder value was also personally beneficial to the members of the management team.

Another important component of company culture was a strong commitment to efficiency and controlling costs. The snack foods industry was very competitive, with Hill Country facing off against industry giant PepsiCo and smaller companies like Snyder's-Lance every day. Efficient operations and tight cost controls were necessary conditions for success; the company could not rely on price increases in this high rivalry industry. Operating and capital budgets were lean and aggressive, and Keener himself was actively involved in both the budget approval process and in ensuring the business was managed to the numbers in the budget. Unfavorable cost variances resulted in management action to bring costs back into line with plans, even when the cost increases were due to external factors. Management didn't always have a solution to unfavorable variances, but they did all they could to keep costs under control.

The final component of Hill Country's culture and managerial philosophy was caution and risk-aversion. The company invested in new capacity and new products when attractive opportunities were identified, but it did not make high-risk bets in its product markets. Growth was low-risk and incremental, driven by extensions of existing products and the acquisition of smaller specialty companies. This strategy produced sales growth rates that were steady, if unspectacular, but also increased the likelihood that customers would respond favorably to the company's new products. Management avoided great leaps in its product markets, instead believing a series of small but successful product launches, combined with the company's operating and cost efficiencies, would quickly contribute positive operating profits.

Hill Country's culture of risk-avoidance was also manifested in its financing decisions. The CEO had strong preferences for equity finance and against debt finance, and the company was managed consistent with these beliefs. Debt was avoided, investments were funded internally, and the balance sheet was strong. The company also held large cash balances to increase both safety and flexibility. Some members of the analyst and investment communities questioned these policies, but CEO Keener believed they were appropriate for the company.

Financial Performance

The combination of good products, efficient and low-cost operations, and all-equity funding had produced consistently strong financial results, as presented in **Exhibit 1**. Sales had increased at a steady rate, and except for the difficult economic years of 2007 and 2008, net income had followed a similar growth pattern. The company had experienced a decrease in earnings in 2007, and struggled to increase profitability in 2008, but growing sales and continued attention to costs drove large increases in net income since the recession ended in 2009. Return on asset and return on equity numbers had similarly increased in the past few years, with return on assets reaching 10%, and return on equity exceeding 12% in 2011. Hill Country's cautious growth strategy also allowed the company to pay continuous and growing dividends; carefully considered and controlled growth meant the company's cash flow was sufficient to fund both capital investments and dividend payments to shareholders. The dividend payout ratio had been just below 30% of net income in each of the past five years, and management planned to maintain this distribution ratio.

The company's cash position and conservative capital structure, however, had a negative impact on its financial performance measures. Return on assets was reduced by Hill Country's large cash balances in two ways. The interest rate earned on invested cash was barely over 0%, contributing almost nothing to net income, and more cash meant more total assets. Return on equity was similarly reduced by the avoidance of debt and complete reliance on equity capital. Hill Country's common stock was widely held by investors and covered by analysts, reflecting the stock market's favorable opinion of the company's products, prospects, and management. Many members of the investment community were also frustrated by the company's excess liquidity and lack of debt finance. Even modest reductions to cash, increases to debt, and reductions to owners' equity would significantly increase return on equity. There was no clear consensus about this issue, however, as others worried about the wisdom of demanding changes from a successful company.

Capital Structure

Cash holdings of U.S. non-financial corporations had increased to record levels by the end of 2011;[1] thus Hill Country's large and growing cash balances were not unusual. The company's capital structure with zero debt finance, in contrast, was fairly unique, particularly within its industry. Both PepsiCo, the giant in snack foods, and Snyder's-Lance, a competitor of similar size and scope utilized debt finance, as shown in **Exhibit 2**. PepsiCo's debt-to-capital ratio was 49.6%, but it earned bond ratings of "Aa" from Moody's and "A" from Standard & Poor's, due to its strong interest coverage and low level of business risk. This ratio was lower for Snyder's-Lance, but debt still provided nearly one-fourth of the company's investment capital. None of their debt was publicly held, however, so Snyder's-Lance was not rated by any credit agency.

The question posed to Keener in the January analyst conference call reflected the opinion of many shareholders that the company would benefit from a more aggressive capital structure policy. Debt was less expensive than equity due to its contractual nature and priority claim, and interest payments were deductible for income tax purposes. In addition, interest rates were at unprecedented levels in early 2012: market yields on 10-year treasury bonds were under 2%; and publicly-traded 10-year bonds issued by "A" rated corporations were trading at 3.8% yields to maturity. These data and other current information about interest rates and bond ratings are presented in **Exhibit 3**.

A pro forma financial analysis is presented in **Exhibits 4** and **5**, which was prepared to address speculation about how a change to Hill Country's capital structure would affect its financial results. **Exhibit 4** shows the company's actual 2011 financial results and pro forma restatements of 2011 results under three alternative capital structures: 20% debt-to-capital; 40% debt-to-capital; and 60% debt-to-capital. **Exhibit 5** presents the details and assumptions of the recapitalizations that produce the alternative pro forma capital structures, in every case assuming the company issued debt and used the proceeds, plus $55 million of excess cash, to repurchase common stock at the end of January 2012. The pro forma analysis also assumes the repurchase premiums paid above the current market price of $41.67 per share increase as the stock repurchase increases in size. Other alternatives exist to significantly increase the proportion of debt in the firm's capital structure—issuing debt to fund a large specially-designated dividend, for example—but **Exhibits 4** and **5** present an analysis that

[1] "Largest Public Companies Continue to Hoard Cash at Record Levels; 1000 of the Largest Now Hold $850 Billion in Cash on Hand," REL Research, December 8, 2011.

estimates the financial impact of increasing debt and decreasing equity in Hill Country's capital structure through a stock repurchase.

Given the company's culture of caution and risk-aversion, it would be unrealistic for analysts and external shareholders to expect a major and immediate change in the use of debt finance, no matter how attractive the pro forma results presented in **Exhibits 4** and **5**. The recent birthday and pending retirement of CEO Keener, however, whose personal preferences had a substantial influence on company culture, created speculation that a more aggressive capital structure might be implemented in the near future. The questions being considered by many members of the investment community were, "What is the optimal capital structure for Hill Country Snack Foods, and how large are the payoffs associated with a change to a more leveraged capital structure?"

Exhibit 1 Selected Financial Information for Hill Country Snack Foods Company, 2006 to 2011
(millions of dollars, except for per share data and financial ratios)

	2006	2007	2008	2009	2010	2011
Sales	$1,027.0	$1,059.9	$1,099.5	$1,180.4	$1,261.7	$1,364.6
Operating income (EBIT)	$97.4	$79.1	$82.8	$108.2	$126.7	$151.3
Net income	$64.6	$52.6	$53.8	$68.1	$79.9	$97.6
Earnings per share	$1.91	$1.56	$1.59	$2.01	$2.36	$2.88
Dividends per share	$0.45	$0.45	$0.45	$0.60	$0.70	$0.85
Cash & cash equivalents	$108.1	$107.6	$106.4	$139.8	$164.8	$181.1
Total assets	$668.5	$727.3	$770.4	$824.9	$894.7	$979.9
Debt	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Owners' equity (book value)	$529.7	$567.4	$606.3	$654.6	$710.9	$780.1
Common shares outstanding (in millions)	33.7865	33.8076	33.8278	33.8581	33.8633	33.8834
Annual growth rate of sales	n/a	3.2%	3.7%	7.4%	6.9%	8.2%
Annual growth rate of E.P.S.	n/a	-18.3%	1.9%	26.4%	17.4%	22.0%
Dividend payout ratio	23.6%	28.8%	28.3%	29.9%	29.7%	29.5%
Net profit margin	6.3%	5.0%	4.9%	5.8%	6.3%	7.2%
Return on assets[a]	9.7%	7.2%	7.0%	8.3%	8.9%	10.0%
Return on equity[a]	12.2%	9.3%	8.9%	10.4%	11.2%	12.5%

[a] Return on assets and return on equity are calculated as net income divided by end of year total assets, and end of year owners' equity, respectively.

Exhibit 2 Comparison Financial Information for Hill Country and Competitors, 2011 (millions of dollars, except for per share data and financial ratios)

	Hill Country Snack Foods	Snyder's-Lance, Inc.	PepsiCo, Inc.
Sales	$1,364.6	$1,635.0	$66,504.0
5-year compounded annual growth rate	5.8%	17.5%	13.6%
Net income	$97.6	$38.3	$6,443.0
% of sales	7.2%	2.3%	9.7%
5-year compounded annual growth rate	8.6%	16.6%	2.7%
Cash and cash equivalents	$181.1	$20.8	$4,067.0
Accounts receivable	$127.4	$143.2	$6,912.0
Inventory	$93.2	$106.3	$3,827.0
Property, plant & equipment, net of depreciation	$281.9	$313.0	$19,698.0
Goodwill & other intangibles	$222.6	$743.9	$33,245.0
Other assets	$73.7	$139.6	$5,133.0
Total assets	$979.9	$1,466.8	$72,882.0
Debt	$0.0	$258.2	$20,568.0
% of capital	0.0%	23.5%	49.6%
Owners' equity (book value)	$780.1	$838.6	$20,899.0
% of capital	100.0%	76.5%	50.4%
Common shares outstanding (in millions)	33.8834	67.4000	1,576.0000
Earnings per share	$2.88	$0.57	$4.08
5-year compounded annual growth rate	8.6%	-0.4%	3.6%
Dividends per share	$0.85	$0.64	$2.03
5-year compounded annual growth rate	13.6%	0.0%	11.8%
Stock price at the end of 2011	$41.67	$22.50	$66.35
P/E ratio	14.47	39.47	16.26
Net profit margin	7.2%	2.3%	9.7%
Return on assets	10.0%	2.6%	8.8%
Return on equity	12.5%	4.6%	30.8%
Interest coverage (times)	n/a	6.67	11.25
Ratio of debt to total capital (book value)	n/a	23.5%	49.6%
Bond rating (Moody's/Standard & Poor's)	n/a	n/a[a]	Aa/A

[a] The debt issued by Snyder's-Lance consists of bank loans, private placement notes, and a revolving equipment credit facility. This debt is not rated by any credit agency.

Exhibit 3 Current Interest Rates and Bond Ratings Information

Interest rates on U.S. Treasury bonds[a]						
Yield to maturity on 10-year maturities	1.8%					

	Bond Rating					
Interest rates on corporate bonds[a]	AAA	AA	A	BBB	BB	B
Yield to maturity on 10-year maturities	2.5%	3.2%	3.8%	4.4%	6.1%	7.7%

	Bond Rating					
Standard & Poor's medians for 2011	AAA	AA	A	BBB	BB	B
Debt-to-capital ratio (book value)	13.8%	29.6%	33.8%	40.4%	47.0%	62.3%
Interest coverage (times)	64.7	15.8	9.6	4.1	2.4	1.3

[a] Market interest rates during January of 2012

Sources: Standard & Poor's, Compustat, Datastream, and U.S. Department of Treasury

Exhibit 4 Pro Forma 2011 Financial Information for Alternative Capital Structures (millions of dollars, except for per share data and financial ratios)

		Pro Forma 2011 for		
	Actual 2011	**20% Debt-to-Capital**	**40% Debt-to-Capital**	**60% Debt-to-Capital**
Sales	$1,364.6	$1,364.6	$1,364.6	$1,364.6
Operating income (EBIT)	$151.3	$151.3	$151.3	$151.3
Interest expense	$0.0	$4.1	$12.8	$33.5
Income before income taxes	$151.3	$147.2	$138.5	$117.8
Income taxes	$53.7	$52.3	$49.2	$41.8
Net income	$97.6	$94.9	$89.3	$76.0
Dividends paid to common stockholders	$28.8	$28.5	$26.8	$22.8
Common shares outstanding	33,883,400	29,709,777	26,983,400	24,476,604
Earnings per share	$2.88	$3.19	$3.31	$3.11
Dividends per share	$0.85	$0.96	$0.99	$0.93
Interest coverage ratio (times)	n/a	36.90	11.82	4.52
Debt	$0.0	$145.0	$290.0	$435.0
Owners' equity (book value)	$780.1	$580.1	$435.1	$290.1

Exhibit 5 Details and Assumptions of the Pro Forma Recapitalizations Presented in **Exhibit 4**

1. Debt is issued and added to the capital structure and the proceeds are used to repurchase common stock. All debt is issued and shares are repurchased at the end of January 2012.

2. Common stock is repurchased at a premium to the market price of $41.67 per share. This premium increases as the size of the recapitalization and repurchase increases. The recapitalization that increases the debt-to-capital ratio to 20% is assumed to require a 15% premium to repurchase the required shares; the 40% debt-to-capital ratio is assumed to require a 20% premium; and the 60% debt-to-capital ratio is assumed to require a 25% premium. Supply curves are upward sloping, so increasing the size of the stock repurchase implies higher premiums.

3. The minimum cash balance is assumed to be $126.1 million, equal to 9.2% of sales, which is 1.5 times the cash to sales ratio of PepsiCo. Hill Country does not have the large and sophisticated treasury operation of PepsiCo, so a higher cash-to-sales ratio is appropriate.

4. The corporate income tax rate is 35.5%.

5. The dividend payout ratio is 30%.

6. The quality of the debt issued by Hill Country decreases and the interest rate on this debt increases as the amount of debt issued and the size of the recapitalization increases. At 20% debt-to-capital the assumed bond rating is AAA/AA and the interest rate is 2.85%, at 40% debt-to-capital the assumed bond rating is BBB and the interest rate is 4.4%, and at 60% debt-to-capital the assumed bond rating is B and the interest rate is 7.7%. The debt issued has a maturity of 10 years.

7. Short-term interest rates in January of 2012 were at historically low levels, for example, 0.17% on one-month CD's. Consequently, although Hill Country holds significant cash and equivalents, interest income earned on invested cash balances is assumed not to be material, and will not change when cash is used to repurchase shares.

8. The details of the 3 recapitalizations are ($ in millions except per share information):

	20% Debt-to-Capital Ratio	**40% Debt-to-Capital Ratio**	**60% Debt-to-Capital Ratio**
Excess cash	$55.0	$55.0	$55.0
Debt issued	$145.0	$290.0	$435.0
Total stock repurchase	$200.0	$345.0	$490.0
Price per share repurchased	$47.92	$50.00	$52.09
Shares of common stock repurchased	4,173,623	6,900,000	9,406,796
Owners' equity (book Value)	$580.1	$435.1	$290.1